Calendar No. 972

99TH CONGRESS
2d Session

SENATE

REPORT
99-480

EXTENSION OF THE DEFENSE PRODUCTION ACT

SEPTEMBER 23 (legislative day, SEPTEMBER 15), 1986.—Ordered to be printed

Mr. HEINZ, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[To accompany S. 2855]

The Committee on Banking, Housing, and Urban Affairs, to which was referred S. 2855 to extend the Defense Production Act of 1950, as amended, having considered the same, reports favorably thereon with an amendment in the nature of a substitute and recommends that the bill as amended do pass.

PURPOSE OF THE LEGISLATION

S. 2855 extends the expiring titles of the Defense Production Act of 1950 for 3 years until September 30, 1989. The extended titles of the Act maintain the national defense industrial production base in peacetime, prepare mobilization programs, and provide a pool of trained manpower for war production management.

Titles I, III and the nonpermanent sections of title VII of the Defense Production Act [DPA] have been regularly renewed by the Congress. Title I provides authorizations for the Defense Priorities, an energy priorities system and for the management of these systems. Title III authorizes the President to guarantee loans and to take other financial measures, including purchase guarantees, to expand productive capacity and supply in the interest of national defense. Amendments adopted under the 1984 extension of the Act of title III authorize the Defense Department: (1) To offer financial incentives to produce materials or retain services critical to national defense, where it is determined that market forces would not otherwise provide those materials or services. Under these amendments, title III projects under $25 million must be identified in the budget sent to Congress, and must meet four requirements: First, the material or service must be essential to the national defense.

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Second, without the financial incentive, the United States industry would not be reasonably expected to provide the capability or the material or service in a timely manner. Third, the financial incentive used must be the most cost-effective, expedient and a practical alternative for meeting the need involved; and finally, the national defense demand must be equal to or greater than the output of domestic industrial capacity which the President reasonably determines to be available for national defense. Title VII prohibits discrimination against small business firms and provides for the national Defense Executive Reserve. The permanent provisions of title VII authorize the promulgation of cost accounting standards to cover government contractors and permit the President to grant antitrust immunity to industrial defense purposes at the request of the President.

The remaining provisions of the Act contained in titles II, IV, V, and VI have not been renewed since the period following the end of the Korean war, and are not affected by this extension of the Act. These standby provisions provide wartime authority for condemnation, price and wage stabilization, the settlement of labor disputes and control of consumer and real estate credit.

AMENDMENT TO THE EXPORT ADMINISTRATION ACT AMENDMENTS OF 1985

Section 3 of the bill would amend section 116(d) of the Export Administration Amendments Act of 1985, to postpone for 1 year, until October 1, 1987, the effective date for the establishment of the position of Under Secretary of Commerce for Export Administration and two positions of Assistant Secretary of Commerce to assist the Under Secretary. In taking this action the Committee does not intend to indicate any reduced need for this position. The Committee continues to consider the establishment of this position as one of the more important provisions in the 1985 amendments, one that will make a significant long-term improvement in terms of directing adequate emphasis, attention, and resources to export administration.

The amendment in this bill merely recognizes that the recent reorganization of export administration operations at the Department of Commerce, coupled with a failure to account sufficiently in fiscal year 1987 budget estimates for the transition to the new Under Secretary framework, indicated that it would be wise to put off this change for one year. The Committeee expects the administration to give priority in budgeting for fiscal year 1988 to providing the resources necessary for the transition. The Commerce Department should have at this point a clearer idea of what those costs should be. The Committee does question, however, why the cost of this transition would amount to as much as $5 million, as indicated in some Commerce Department estimates. It should be possible to accomplish this change at a much lower cost.

The Committee favorably notes the significant improvement that has occurred in interagency cooperation in the area of export controls since the enactment of the 1985 amendments. This has undoubtedly improved the effectiveness of our export controls in achieving their vital national security, foreign policy, and short

supply objectives. In a time of budget concern and limited defense spending, an effective national security export control system is essential to our national safety. The preservation of the technological advantage of our weapons has become an undeniable chief element of our defense, which relies on a significant qualitative edge to offset a massive Soviet bloc quantitative advantage.

COST ACCOUNTING STANDARDS BOARD

The Committee recognizes the need to transfer the Cost Accounting Standards Board functions to an executive agency that could administer the standards or to a newly created independent agency. The Committee did not have the time during this session of Congress to address this issue, but intends to hold hearings early next year to explore proposals to reestablish a Cost Accounting Standards Board or transfer CAS functions to an existing executive agency.

In the interim, the Committee directs the Department of Defense to discontinue exercising any of the responsibilities and authorities which previously rested with the Cost Accounting Standards Board under Public Law 91-379.

SECTION-BY-SECTION ANALYSIS

Secion 1 provides for an extension of the Defense Production Act for a period of 3 years from September 30, 1986 to September 30, 1989.

Section 2 authorizes appropriations of not more than $150,000,000 for fiscal years 1987, 1988, and 1989. For fiscal year 1987, the authorization is limited to $30,000,000.

Section 3 postpones for 1 year the creation of the position of Under Secretary of Commerce for Export Administration to October 1, 1987.

REGULATOR IMPACT STATEMENT

In compliance with paragraph 11(b)(of Rule XXVI of the Standing Rules of the Senate, the Committee has evaluated the regulatory impact and the paperwork impact which would be incurred by carrying out this bill.

Section 1 of this bill merely extends for 3 years the authority for existing regulations issued for the administration of the Defense Production Act. No new regulatory requirements are created. Section 2 of the bill authorizes appropriations for DPA title III projects, and does not create any new regulatory requirements. Section 3 of the bill merely postpones creation of a new position established by the Export Administration Amendments Act of 1985 for 1 year, and does not create new regulatory requirements.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., September 19, 1986.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the attached cost estimate for a bill extending the expiration date of the Defense Production Act of 1950, as ordered reported by your Committee on September 17, 1986.

Should the Committee so desire, we would be pleased to provide further details on the attached cost estimate.

With best wishes,

Sincerely,

JAMES BLUM
(For Rudolph G. Penner,
Director of Congressional Budget Office).

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

1. Bill number: Unassigned.

2. Bill title: A bill to extend the expiration date of the Defense Produciton Act of 1950.

3. Bill status: As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, on September 17, 1986.

4. Bill purpose: This bill amends Title VII of the Defense Production Act of 1950 by changing the expiration date from September 30, 1986 to September 30, 1989. The Act authorizes the following programs:

Industrial defense mobilization activities of the Department of Commerce;

Certain emergency preparedness activities funded in the Federal Emergency Management Agency; and

The administration and disposal of inventory of materials procured under section 303 of the Defense Production Act. This is funded within the General Services Administration under the Federal Property Resources account.

This bill also amends section 711(a)(4) of the act by placing restrictions on the use of Title III authority to make purchases and to provide loans, loan guarantees, or purchase commitments.

Finally, section 3 of this bill postpones for 1 year the Export Administration Amendments Act of 1985.

5. Estimated cost to the Federal Government: For the 3-year extension of the Defense Production Act, estimated authorizations are approximately $150 million with associated outlays of approximately $60 million. These costs fall within budget functions 050 and 370.

The 1 year extension of the Export Administration Amendments Act of 1985 avoids authorization of up to $5 million with total associated outlays of $5 million. These savings fall within function 370.

[By fiscal year, in millions of dollars]

	1987	1988	1989	1990	1991
Extension of the Defense Production Act termination date to September 30, 1989:					
Budget function 370:					
Estimated authorization level	0.2	0.2	0.2	0.0	0.0
Estimated outlays	0.2	0.2	0.2	0.0	0.0
Budget function 050:					
Estimated authorization level	37.0	59.0	57.0	0.0	0.0
Estimated outlays	8.5	8.8	12.4	14.2	14.2
Postponement of the Export Administration Amendments Act to October 1, 1987:					
Budget function 370:					
Estimated authorization level	−5.0	0.0	0.0	0.0	0.0
Estimated outlays	−3.5	−1.5	0.0	0.0	0.0
Total cost:					
Estimated authorization level	32.2	59.2	57.2	0.0	0.0
Estimated outlays	5.1	7.5	12.6	14.2	14.2

Basis for estimate: This estimate assumes that the full amount of authorizations will be appropriated prior to each fiscal year.

The estimate for the cost of extending the existing provisions of the Defense Production Act is based on the Administration's plans for 1987 through 1989. These would require slightly more than $0.2 million for the Department of Commerce mobilization activities and approximately $1.0 million for the activities carried out by the Federal Emergency Management Agency for each fiscal year of the extension.

Section 2 of this bill provides authorizations of up to $150 million for purchases of materials under section 303 of the Defense Production Act. The bill specifies that of the $150 million, not more than $30 million is authorized for 1987. This equals the amount included in the Administration's request for fiscal year 1987. The remaining authorizations were assumed to be divided equally between fiscal years 1988 and 1989. Outlays were estimated based upon rates experienced for the Defense Production Act purchases procurement account.

Section 2 also provides that these authorizations may be used for direct loans, loan guarantees, purchase agreements and other actions under sections 301, 302 and 303 of the Defense Production Act. The Department of Defense plans to use $6 million in 1987 and $2 million in 1988 for these purposes, but has no future plans to use this authority. Other agencies with the authority to use these funds have no plans to draw upon the authority. Outlays are estimated at the rates employed by the Administration in their budget request.

Section 3 delays the creation of an office in the Department of Commerce headed by an Under Secretary and two Assistant Secretaries for Export Administration to carry out the Export Administration Amendments Act of 1985. To the extent that Congress would have funded this office for fiscal year 1987, up to $5 million in budget authority and up to $3.5 million in outlays would be avoided.

6. Estimated cost to State and local governments: None.

7. Estimate comparison: None.
8. Previous CBO cost estimate: None.
9. Estimate prepared by: Barbara Hollinshead and Carol Cohen.
10. Estimate approved by C.G. Nuckols for James L. Blum, Assistant Director for Budget Analysis.

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Calendar No. 978

99TH CONGRESS *2d Session*	SENATE	REPORT 99-486

BUSINESS ACCOUNTING AND FOREIGN TRADE SIMPLIFICATION ACT

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 430

together with

ADDITIONAL VIEWS

SEPTEMBER 24, 1986.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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CONTENTS

	Page
Committee deliberations	1
Purpose of the legislation	2
History and background of the legislation	2
Need for the legislation	3
Nature and scope of the bill	5
Amendments to the accounting provisions	5
Records of subsidiaries	10
Amendments to the antibribery provisions	11
Section-by-section analysis of the bill	13
Fiscal impact statement	16
Regulatory impact statement	17
Changes in existing law	18
Additional views of Senator Proxmire	19

Calendar No. 978

99TH CONGRESS
2d Session

SENATE

REPORT
99-486

BUSINESS ACCOUNTING AND FOREIGN TRADE SIMPLIFICATION ACT

SEPTEMBER 24, 1986.—Ordered to be printed

Mr. HEINZ, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 430]

The Committee on Banking, Housing, and Urban Affairs, to which was referred the bill (S. 430) to amend and clarify the Foreign Corrupt Practices Act of 1977, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

COMMITTEE DELIBERATIONS

The precursor of this bill was first introduced in the 97th Congress by Senator Chafee with 13 cosponsors on March 12, 1981 as S. 708. Joint hearings on the bill were held before the Senate Banking, Housing, and Urban Affairs Subcommittee on Securities and the Subcommittee on International Finance and Monetary Policy on May 20 and 21, June 16, July 23 and 24, 1981.

The Committee met in open executive session on September 16, 1981 and agreed to report S. 708 favorably with an amendment. The bill was taken to the Senate floor on November 23, 1981 and passed by a voice vote with six amendments.

Senators Heinz, Chafee, Garn, and D'Amato introduced S. 414 (in the same form as S. 708 which passed the Senate in 1981) on February 3, 1983. A joint hearing on the bill was held by the Subcommittee on Securities and the Subcommittee on International Finance

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and Monetary Policy on February 24, 1983. The full Committee agreed to poll vote of 17 yeas and 1 nay to report S. 414 on May 25, 1983.

On February 7, 1985, Senators Heinz, Chafee, Garn and D'Amato introduced S. 430 (in the same form as S. 414 and S. 708). A joint hearing on the bill was held by the Subcommittee on International Finance and Monetary Policy and the Subcommittee on Securities on June 10, 1986. Testimony was received from Malcolm Baldrige, Secretary of Commerce; Edward H. Fleischman, Commissioner of the Securities and Exchange Commission; John C. Keeney, Deputy Assistant Attorney General, Criminal Division, Department of Justice; Calman J. Cohen, vice president, Emergency Committee for American Trade; Allen B. Green, partner, McKenna, Connor and Cuneo, representing the public contract law section of the American Bar Association; and Arthur F. Matthews, partner, Wilmer, Cutler and Pickering.

On September 17, 1986, the full Banking Committee agreed to report S. 430 by a vote of 11 yeas to 3 nays.

PURPOSE OF THE LEGISLATION

The legislation would amend the Foreign Corrupt Practices Act of 1977 (the "FCPA") in order to address a number of significant problems identified with the Act's implementation. In making these changes, the bill expressly adopts the view that the principal goal of the FCPA—outlawing bribery by United States corporations of foreign officials—is a worthwhile goal which should continue to be pursued.

At the same time, however, the bill recognizes that troublesome and often unnecessary problems have arisen under the FCPA, in many instances because of the lack of clarity in the Act and the different interpretations which have arisen concerning its meaning. As a result of these unnecessary interpretive problems, U.S. businesses have lost legitimate export opportunities and have incurred unreasonable costs in attempts to comply with the FCPA's provisions. These problems can be expected to continue until the Act is amended.

HISTORY AND BACKGROUND OF THE LEGISLATION

The FCPA was enacted in 1977 in response to disclosures of questionable and in some cases illegal foreign payments made by U.S. companies to foreign officials in order to secure export business. The Act created both civil and criminal penalties for violation of "antibribery" provisions which outlaw payments made to foreign officials to secure business. Because many of the payments disclosed were made by foreign sales representatives of the U.S. companies, the Act included a provision designed to establish the circumstances under which a U.S. concern or its officers would be held responsible for a payment made by a representative.

In order to complement the anti-bribery provision, the Act also included "accounting provisions" applicable to companies which file periodic reports with the Securities and Exchange Commission. These provisions require each issuer to make and keep accurate accounting records and to devise and maintain internal accounting

controls providing "reasonable assurances" that specified goals are met. These goals, which were borrowed from authoritative accounting literature, generally involve proper recording of economic events affecting the corporation and adequate safeguarding of its assets in accordance with accepted accounting practices.

The purposes of both the anti-bribery provisions and the accounting provisions were and remain laudable; indeed, the Senate twice passed bills unanimously which adopted these provisions in similar form.

Unfortunately, implementation of these and related provisions of the FCPA has demonstrated that the lack of clarity in the provisions, and have created unacceptable and unnecessary burdens on those required to comply with the statute. As a result, the direct and indirect costs of compliance with the FCPA and the lost opportunities of U.S. businesses have been excessive, and there is a compelling need to re-examine and refine the provisions of the Act in order to reduce or eliminate unnecessary compliance costs, without undermining the basic purposes of the FCPA.

NEED FOR THE LEGISLATION

Since passage of the Foreign Corrupt Practices Act in 1977, the need for substantial revision of the law has been widely recognized. The record spanning five years of Banking Committee consideration of this issue is clear. In July 1981 hearings, the Honorable Robert Graham, Governor of Florida, testified on behalf of the National Governors Association:

> The point I want to emphasize is that this is not a partisan issue and concern did not originate this year or with the administration of President Reagan.
>
> The Governors Association, a bipartisan organization, began studying this issue in 1978 and endorsed a revision of the act in early 1980.
>
> President Carter concluded in his report to Congress on export disincentives that this act "* * * inhibits exporting because of uncertainty within the business community about the meaning and application of some of its key provisions * * *."

Also during the 1981 hearings, Theodore C. Sorenson, a strong advocate of the FCPA in 1977, stated:

> To refine the 1977 law, however, to make it more certain and less cloudy, to sharpen its focus on corrupt practices by reducing the threat that its broad ambiguities pose to innocent conduct, would be highly desirable. The vague and sweeping language of the present law has to my personal knowledge caused some wholly honorable entreprenuers to stop doing business abroad and caused others to erect distorted and inefficient business structures as a shield against any unintended liability.

These concerns were reiterated in the hearings held by the Committee on June 10, 1986. Secretary Baldrige restated the Administration's support for clarifying the FCPA as a means of expanding U.S. exports.

> It is also clear from the experience we have gained over the eight years the Act has been in effect that it is not as clear as it could be. The business community has stated repeatedly that it is not sure what practices are prohibited and what practices are permitted under the Act. This uncertainty has increased the cost of conducting international business. These costs, combined with the threat of adverse publicity that results from even unfounded allegations of violations of the Act, have caused U.S. firms to be overly cautious and to forego legitimate business. This problem is particularly severe for small and medium-sized firms who cannot afford to hire Wall Street law firms to guide them through the complexities of the Act. With U.S. firms meeting fierce competition in the international market place, we cannot afford to place needless hurdles in the way of legitimate exports.

Commenting on the hurdles faced by members of his organization, the Emergency Committee for American Trade, Calman J. Cohen noted the results of a poll conducted among his members in which companies identified losses of business opportunities totaling over $2 billion they attributed to ambiguities in the law.

Turning to the anti-bribery provisions, criticism has focused on the issues of third party liability and the definition of the types of facilitating payments and other expenses that should not be prohibited under the legislation. The ambiguity and lack of clarity of the law's "reason to know" standard for the actions of agents was highlighted in the 1981 hearings. It was characterized as especially problematic for small business that must operate overseas through foreign agents. These concerns were restated in the June 1986 hearings by Allen B. Green, representing the Public Contract Law Section of the American Bar Association.

> The effect of the uncertainty in application of the "reason to know" standard is that we of the Section cannot advise our clients that (inadvertent) conduct will be treated any less harshly than intentional bribery, which has the natural effect of discouraging international transactions.
>
> Notably, the chief enforcement arm of the U.S. government—the Department of Justice—views the "reason to know" standard as an inappropriate and harsh standard for criminal prosecution. In a July 1982 memorandum to the staff of the House Committee on Energy and Commerce, Deputy Attorney General Edward Schmults stated:
>
> "In the Department of Justice's estimation, the 'reason to know' standard of the current law is plainly inappropriate. It is harsh and inconsistent with the general approach of modern criminal law to state of mind requirements."

Defining permissible payments, the so-called facilitating payments which the drafters of the FCPA intended to exempt, has been a major concern since the law was passed. The FCPA dealt indirectly with this issue by defining the type of "official" involved with a payment. Payment can legally be made to "any employee of

a foreign government or any department, agency or instrumentality thereof whose duties are essentially ministerial or clerical." This approach has been criticized as vague because it does not focus on the intent of the payments themselves. Calman Cohen noted that even in the U.S. Government it is difficult to know when an official has "essentially ministerial or clerical" duties; in foreign countries, where duties are less clearly articulated and unavailable in published form, the problem is much more serious.

Business and Administration witnesses have argued in favor of a definition of payments that focuses on the intent of the payments themselves, the approach taken in S. 430, since the question of bribery turns on why, rather than to whom, a payment is made. Deputy Assistant Attorney General Keeney indicated that the exceptions in S. 430 would resolve ambiguities in the law and suggested a series of clarifications to further strengthen this excepted payments language. The discussion of the provisions of S. 430 below address each point raised by Justice and incorporates a number of specific recommendations.

The second major area of concern with the FCPA is the law's accounting provisions which establish both bookkeeping and internal control requirements, subject to both criminal and civil presecution. As with the anti-bribery provisions, Administration and business witnesses have criticized this area of the law as ambigious, and have argued that the indefinite standard of performance in the law combined with possible criminal penalties for faulty bookkeeping has generated significant waste as businessmen have built excessive protections against error into their accounting systems.

The concern that inadvertent errors could expose a firm to criminal prosecution caused such concern in the business community that the Securities and Exchange Commission issued clarifying guidance on proposed enforcement of the law in 1981. At the June, 1986 hearings, SEC Commissioner Edward Fleischman noted that in its 1981 policy statement, the SEC recognized that the accounting provisions must be—

> * * * limited by a concept of reasonableness that tolerates certain deviations from the idea and contemplates a cost-benefit analysis. The Commission also stated that the principal purpose of the accounting provisions is to reach knowing or reckless conduct.
>
> In its enforcement efforts under the accounting provisions of the FCPA, the Commission has adhered to its 1981 Statement of Policy. The cases have not involved insigificant or technical infractions, nor have individuals been charged with inadvertent conduct. The proposed amendments (in S. 430) would generally codify the Commission's Statement of Policy, and we support the bill.

NATURE AND SCOPE OF THE BILL

1. Amendments to the accounting provisions

The accounting provisions of the Foreign Corrupt Practices Act, contained in Section 13(b)(2) of the Securities Exchange Act of 1934, were enacted as a complement to the anti-bribery provisions, and

were designed to establish minimum record-keeping and internal accounting controls standards for issuers registered with or reporting to the Securities and Exchange Commission.

The provisions, however, are not expressly tied to the anti-bribery sections of the FCPA, and their reach extends to transactions and to issuers which are not involved, directly or indirectly, in exports.

The existing accounting provisions require each issuer subject to the requirements to—

> (A) make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
>
> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
>
> (i) transactions are executed in accordance with management's general or specific authorization;
>
> (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
>
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
>
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

As now constituted, these provisions have proven to be overly burdensome requirements which have caused businesses to incur costs substantially in excess of the benefits derived from these expenditures.

This has occurred for several reasons:

1. As enacted in 1977, the accounting provisions arguably consist of two separate requirements: first, each issuer is required to maintain specified types of books and records; secondly, internal accounting controls must be maintained which meet the tests enumerated in subparagraph (B).

Since 1977, there has existed considerable uncertainty about the standards required by the two parts of the provisions, and the relationship between them. In particular, concerns have been expressed that the recordkeeping provision demands a degree of precision in accounting records which is unattainable in practice.

In this regard, it is widely acknowledged that *no* system of internal accounting controls, no matter how extensive, can prevent all errors or inaccuracies in a company's records. In recognition of this fact the Committee believes that the appropriate focus of the accounting provisions should be upon the internal accounting controls system maintained by an issuer rather than upon whether particular inaccuracies exist. The existence of a separate recordkeeping provision has created significant problems of interpretation and has led to justifiable concern that small errors which do

not undermine the internal accounting controls system, or false or inaccurate records that are detected in the ordinary course of a company's operations, would be considered violations of the statute. This danger exists under present law regardless of whether the records involved have any relationship to foreign operations and apply to companies which have no foreign sales.

There are a number of circumstances apart from the recordkeeping requirements of the FCPA which provide assurances that corporate records will be accurate, and these factors will continue to foster accurate recordkeeping. In light of these circumstances, the benefits of having a separate federal recordkeeping requirement are not sufficient to outweight the interpretive problems that such a provision has created and the unnecessary expenses which have resulted.

The most important factor encouraging accuracy in recordkeeping is the fact that accurate records are necessary for corporate managers to effectively conduct the business of a company. Thus, the accounting provisions in a sense merely require business ventures funded by the investing public to install recordkeeping and control procedures which would appear necessary as a matter of effective management. However, there are inherent difficulties in codifying good business practices in federal law, including the interpretive problems described above.

Aside from the requirements of effective management, accurate records are generally necessary in order to permit issuers to prepare financial statements and to comply with the disclosure requirements of federal securities laws. It is implicit in the requirement that issuers must file materially accurate financial statements that they will be based on books and records which permit them to do so. Serious recordkeeping deficiencies would give rise to violations of the disclosure provisions.

A third factor that encourages issuers to maintain accurate books and records, irrespective of a federal statutory recordkeeping requirement, is the fact that issuer's financial statements must be audited annually. If the auditor discovers sufficiently serious deficiencies in recordkeeping which go uncorrected, he will either give a qualified opinion concerning the financial statements or render no opinion at all.

Another factor encouraging the integrity of corporate recordkeeping is the existence and function of the internal accounting controls provisions. These provide, among other things, that such controls must provide "reasonable assurances" that a company's records will reflect transactions as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, and to maintain accountability for assets. It is in the very nature of a system of internal accounting controls that it should uncover recordkeeping inaccuracies from time to time. Once such matters are brought to light, it is the responsibility of management officials to take such corrective action as may be appropriate in light of the "reasonable assurances" standard in the bill. Accordingly, the internal controls provision makes the failure to take corrective action a violation of law, if the deficiency is so serious that the system of internal accounting controls does not provide the required "reasonable assurances."

Finally, the bill's revision of Section 13(b)(2) would add accurate recordkeeping, in reasonable detail, to the list of statutory objectives of an internal controls system. The addition of accurate recordkeeping as an explicit purpose of the required internal accounting controls is intended to clarify that the deletion of the separate recordkeeping section does not reflect a lessening of the importance of accurate recordkeeping to the attainment of the goals of the accounting provision of the Act.

The use of the word "accurate" has caused some concern that the Act requires a degree of perfection which is neither familiar in accounting literature nor attainable in practice. In this regard, the Committee repeats its explanation of the term in the 1977 report accompanying the bill which became the FCPA:

> * * * the term "accurately" does not mean exact precision as measured by some abstract principle. Rather it means that an insurer's records should reflect transactions in conformity with generally accepted accounting principles or other applicable criteria.

The Committee combined in a single provision the requirements of adequate books and records and of internal accounting controls which provide "reasonable assurances" that the specified statutory objectives are met. By explicitly including within the goals of the internal accounting controls requirement the principle formerly embodied in the separate recordkeeping requirement, the Committee's action reflects that (1) the adequacy of the internal accounting controls system is the appropriate measure of compliance with the statute; and (2) the system must be devised and maintained in a manner which provides reasonable assurances of, among other things accurate and fair books and records. However, the elimination of a separate recordkeeping provision precludes the possibility of an enforcement action based solely on the fact that records are inaccurate.

2. Under the accounting provisions of the FCPA there is currently no explicit "scienter" requirement. Thus the statute may be read to proscribe less than "knowing" violations. Although enactment of the FCPA was based upon the widespread disclosures of intentional acts relating to illegal or questionable payments of U.S. corporate funds to foreign officials, the accounting provisions contain no clear standard for limiting responsibility to intentional actions. The absence of any such standard has led to substantial uncertainty, with some commentators suggesting that inadvertent or innocent errors in a company's books could be the basis of liability. As a result, issuers subject to the accounting provisions have in many cases incurred excessive compliance costs because of a desire to comply with the law and a concern that the Act might ultimately be determined to impose a unduly strict standard of liability.

The Committee believes that the purpose of the FCPA's accounting provision is to require issuers to develop and maintain a system of internal accounting controls which would include the maintenance of accurate books and records. But the Committee desires to make clear that innocent mistakes are not actionable. Thus the Committee fully expects each issuer to in good faith establish internal accounting controls that provide reasonable assurances that

the objectives of the statute have been met. The Committee has provided issuers with a good faith effort defense to any assertion of violation. Once a corporation has been charged with a violation of the internal accounting control requirement, they need only show that they in fact made a good faith effort to comply with the statute's requirements to remove any liability under the statute. In the context of individuals, however, the Committee has provided a "scienter" requirement. Under this standard the SEC must show that an individual egaged in a knowing violation as a prerequisite to a charge of violation. The Committee has also made clear that enforcement of the accounting requirements against issuers is a civil matter not subject to criminal sanctions. The Committee took this action to meet the criticism that potential criminal liability could attach for inadvertant mistakes or errors in judgment. The Committee wishes to stress that it is the establishment of accounting controls by issuers that it desires as a public policy not litigious arguments over trivial erros. However, the Committee did provide for criminal liability against any person knowingly circumventing a system of internal accounting controls. Section 32 of the Securities Exchange Act of 1934 provides the general basis for criminal liability for violation of the Act. It is not intended that the use of the term "knowingly" in new section 13(b)(6) of the Act affect the general requirement that criminal violations of the 1934 Act be "willful".

It should be noted that S. 430 would only require a change in one SEC regulation. In past testimony before this Committee on S. 414 precursor to S. 430, then Chairman Shad stated that the validity of SEC Rules 13b2-1 and 13b2-2, both of which were adopted following enactment of the FCPA, and which prohibit any person from falsifying corporate records and which prohibits corporate officers, directors, and shareholders from misleading auditors, would not be affected by the enactment of S. 414. However, Chairman Shad indicated that the Commission would revise its Rule 13b2-1 interpretive position to include a knowledge requirement.

3. The internal accounting control provision in the current law does not contain any explicit reference to the consideration of the costs and benefits of internal accounting controls, even though there is wide-spread agreement that particular controls or changes in systems of controls should only be required where they produce meaningful benefits in excess of the costs to be incurred. Similarly, the Act does not expressly provide that those responsible for internal accounting controls systems are to be given latitude in making judgments about the appropriateness of controls in particular cases.

The language of the accounting provisions in the Act was borrowed from authoritative accounting literature and, the Committee believes, was premised upon widely accepted auditing and accounting practices. In that connection, this Committee's Report accompanying the bill which became the FCPA indicated that "management must necessarily estimate and evaluate the cost/benefit relationships of the steps to be taken in fulfillment of its responsibilities" under the accounting provisions. However, doubts have continued to exist about the degree of latitude which issuers have in fashioning internal accounting control systems meeting the statuto-

ry objectives as well as about the consequences of an honest error in judgment in connection with a decision about internal controls.

The 1981 hearings preceding the Committee's consideration of S. 708 reflected widespread agreement that cost/benefit criteria should be incorporated into the statute, although different formulations of such a standard were suggested. S. 430 would incorporate by definition of the term "reasonable assurances" the concept that the design and internal accounting controls are the responsibility of the issuer's management having in mind the likely costs and benefits, and, accordingly, their decisions should be accorded discretion.

The use of a cost/benefit test is clearly appropriate with respect to the definition of "reasonable assurances." In fact, Statement on Auditing Standards No. 1, from which the existing accounting provisions were derived, defines "reasonable assurance" as follows:

> The definition of accounting control comprehends reasonable, but not absolute, assurance that the objectives expressed in it will be accomplished by the system. The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control.

The auditing standard adds that:

> Although the cost/benefit relationship is the primary conceptual criterion that should be considered in designing a system of accounting control, precise measurement of costs and benefits usually is not possible; accordingly, any evaluation of the cost/benefit relationship requires estimate and judgments by management.[1]

The reference to cost/benefit analysis in the bill is not intended to suggest or require that a company establish elaborate methodologies in order to measure the implications of changes in internal accounting controls.

Records of subsidiaries

The FCPA accounting provisions have an additional problem with respect to the legal responsibility of an issuer for compliance by subsidiaries with the accounting requirements. The language of the FCPA is silent on this issue, and conflicting views have been expressed concerning the nature of this responsibility, particularly with respect to subsidiaries in which an issuer owns a minority interest.

S. 430 provides that such an issuer's responsibility is discharged where the issuer makes a good faith effort to cause the subsidiary to comply with the amended requirements of Section 13(b)(2). This approach is based upon the recognition that it is not realistic to expect a minority owner to exert a disproportionate influence over the accounting practices of a subsidiary's internal accounting controls. The amount of influence which an issuer may exercise necessarily varies from case to case, depending on a variety of factors.

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[1] American Institute of Certified Public Accountants, codification of *Statements of Auditing Standards*, Section 320.32.

While the relative degree of ownership is obviously one factor bearing on the issuer's influence, other factors may also be important.

The good faith requirement approved by the Committee is intended to be consistent with the other amendments to the FCPA incorporated in S. 430, in that the issuer's conduct, rather than that of persons or entities not subject to the issuer's control, will determine whether or not the issuer is deemed to have violated the internal accounting controls provision.

Amendments to the anti-bribery provisions

Section 5(a) places in the Justice Department all jurisdiction for enforcement of the anti-bribery provisions of the Act. The SEC remains responsible for civil enforcement of the internal accounting controls provisions and relevant securities laws. Under current law the SEC has authority for enforcing against "issuers" the civil remedies for violation of the anti-bribery provisions. The Justice Department enforces against "issuers" the criminal remedies for violation of the anti-bribery provisions and the civil and criminal remedies for such violations against "domestic concerns."

The Committee bill continues the prohibition against foreign bribery, but it is intended to clarify the ambiguities which have caused confusion and lost sales among U.S. exporters attempting to comply with the FCPA.

Section 104 of the FCPA would be repealed and replaced by language which conforms to domestic bribery statutes. The jurisdictional predicate of the FCPA, however, has been retained, and domestic concerns are prohibited from making use of the mails or any other a instrumentality of interstate commerce to make payments for the purpose of influencing any act or decision of a foreign official in his official capacity, or inducing him to do or fail to do any act in violation of his legal duty as a foreign official. Such payments are also prohibited for inducing a foreign official to use his influence to assist a domestic concern in obtaining or retaining business, or to direct business to any person.

Because of the breadth and lack of clarity concerning the "reason to know" standard (see discussion in "Need for the Legislation"), the Committee decided to substitute a new, more precise standard.

The new Section 104(b) would make it unlawful for any domestic concern corruptly to "direct or authorize, expressly or by a course of conduct," a third party to bribe a foreign official.

The Committee intends the term "course of conduct" used with the term "authorize" in Section 104(b) to refer to those situations where a company, through its words or course of conduct, has intended that a corrupt payment be made. For example, a company's refusal or failure to respond to an agent's suggestion or request that a corrupt payment be made would violate this section, as would a company's continuing employment of an agent known to the company to have made corrupt payments in the preceding two years in violation of applicable U.S. laws or those of the country in question.

On the other hand, the mere fact of doing business in a country where corrupt payments are common, or the employment of an agent with personal relationships with government officials in the

country where the company seeks to do business would not establish such a course of conduct. Similarly, the payment of a commission that is higher than customary would not by itself violate this section without evidence that the increased amount of commission is intended to permit a corrupt payment to be made.

The Committee believes that this standard will result in liability being imposed in overseas bribery cases brought under this Act if liability would also be imposed if the case were subject to domestic bribery law.

Likewise, the new Section 104(c) is intended to eliminate the ambiguities of the current law concerning facilitating or so-called "grease" payments. The FCPA contains an exemption for such payments by excluding from the definition of the term "foreign official" an employee "whose duties are essentially ministerial or clerical". Unfortunately, that definition has proved arbitrary and difficult to apply in practice, in part due to the multitude of relationships and responsibilities of employees of foreign countries.

The Committee bill presents a different approach to facilitating and other payments not intended to be covered by the Act, than that embodied in current law. While the FCPA seeks to define facilitating payments in terms of *recipients*, the Committee bill would remove uncertainty about the facilitating payments exception by defining such payments in terms of their *purpose*. It provides for the following exceptions:

Facilitating or expediting payments to a foreign official, the purpose of which is to expedite or secure the performance of a routine government action by a foreign official;

Items lawful under the laws of the foreign official's country;

Items which constitute a courtesy, or a token of regard, or esteem, or in return for hospitality;

Expenditures, including travel and lodging expenses, associated with the selling or purchase of goods or services or with the demonstration or explanation of products;

Ordinary expenditures, including travel and lodging expenses, associated with the performance of a contract.

The Committee wishes to emphasize that the exception for facilitating and expediting payments should not be interpreted to undermine the basic anti-bribery purpose of the statute.

The Committee believes this greater precision is needed in defining exceptions to the Act, given the widely differing interpretations of legitimate facilitating or "grease" payments over the past 8 years and the divergent situations which arise in foreign countries. Clearly this language is not intended to encompass payments either for the obtaining or retaining of business, but it would, for example, cover the processing of export or import licenses in the host country.

The Committee also specifically excludes from the bill's definition of bribery those payments which are "lawful under the laws and regulations of the foreign official's country." In providing this exception, the Committee does not intend to reduce the burden of proof on U.S. companies where the government successfully demonstrates that a case should go forward. A company must be able to defend its actions by documenting that they are in fact "lawful" in the host country.

The Committee also excludes payments which constitute "a courtesy, a token of regard or esteem, or in return for hospitality." A particular dollar value was not placed on such payments in recognition that local customs and practices vary and appropriateness could not therefore be determined solely on the basis of U.S. dollar value. The issue to be resolved in a prosecution would be whether the value was appropriate in the context of the type of transaction being undertaken, local custom and business practices, and the laws and regulations of the host country.

Finally, the Committee excluded expenditures "associated with selling or purchasing goods or services or with the demonstration or explanation of products," while a final exception covers ordinary expenditures "associated with the performance of a contract with a foreign government or agency." The Committee intended these exceptions to apply only in situations involving legitimate, bona fide, and reasonable expenditures made to or for the foreign official in payment for or reimbursement of that foreign official's expenses only.

The bill also addresses the potential problem that conduct which would be lawful under the Business Practices and Records Act could nevertheless be prosecuted under the mail or wire fraud statutes, with prosecution based on the theory that those statutes could be used to allege that a foreign official violates a fiduciary duty to his country. The bill would preclude prosecutions based upon that theory.

The Committee recognizes the continuing need for international agreements outlawing bribery in the international marketplace. The unilateral position currently taken by the United States in terms of anti-bribery legislation, while laudable, constitutes a serious disadvantage to U.S. commerce. The Committee recognizes that bribery warps appropriate trade patterns and distorts the market as an efficient allocator of resources, but it believes that the most useful approach to this problem is a multilateral one.

The Committee bill would enhance U.S. efforts to achieve such international agreement by presenting a statute that effectively curbs bribery without imposing unnecessary trade disincentives. Recognizing this need, the bill calls for renewed efforts, both on multilateral and bilateral levels, to achieve international agreement on the prohibition of bribery.

SECTION-BY-SECTION ANALYSIS OF THE BILL

Short title

Section 1 provides that this legislation may be cited as the "Business Accounting and Foreign Trade Simplification Act."

Findings and conclusions

Section 2 contains five Congressional findings, noting the positive contribution of the Foreign Corrupt Practices Act, the unnecessary concern, cost, and burden posed by some of its provisions, and the interest of all countries in maintaining responsible standards of corporate conduct in foreign markets. Congress reaches four conclusions: that the principal objectives of the FCPA are important to the nation, that exporters should not be exposed to conflicting demands from diverse enforcement agencies, that compliance prac-

tices should be considered in balance with other national objectives and that the U.S. should seek appropriate international cooperation to solve the problem of corrupt payments.

Amendment of short title

Would change the short title of the Foreign Corrupt Practices Act of 1977 to the "Business Practices and Records Act", reflecting the fact that certain provisions of the Act apply to entities irrespective of foreign activities and removing the implication of wrongdoing embodied in the former title.

Accounting standards

Section 4(a) would revise the existing accounting provisions of the law by (1) eliminating the separate provision requiring accurate books and records, and (2) incorporating the principle of the recordkeeping into the statutory objectives of the remaining internal accounting control requirement.

As modifed, the provision would require each issuer subject to the reporting requirements of the Securities Exchange Act of 1934 to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that five specific goals are met.

Section 4(b) would add a new paragraph (6) to Section 13(b) of the Securities Exchange Act to establish a *scienter* standard for violations of the accounting standard committed by individuals.

In addition, a new paragraph (5) would also be added, which defines the responsibility of an issuer with respect to the accounting practices of a domestic or foreign subsidiary in which the issuer owns an interest of 50 percent or less.

Transfer of jurisdiction

Section 5(a) would place in the Justice Department all jurisdiction for enforcement of the anti-bribery provisions of the Act. The SEC would remain responsible for civil enforcement of the internal accounting controls provision. Under current law the SEC has authority for enforcing against "issuers" the civil remedies for violation of the anti-bribery provisions. The Justice Department enforces against "issuers" the criminal remedies for violation of the anti-bribery provisions and the civil and criminal remedies for such violation against "domestic concerns."

Bribery prohibition

Section 5(b) would rewrite section 104 of current law. Subsection (a), designed *inter alia* to bring the Act into conformity with the domestic bribery statues, would prohibit a domestic concern from making use of the mails or any other instrumentality of interstate commerce to make payments for the purposes of influencing any act or decision of a foreign official in his official capacity, or inducing him to do or omit to do any act in violation of his legal duty as a foreign official, or inducing him to so use his influence, for the purposes of assisting the domestic concern in obtaining or retaining business, or of directing business to any person.

Intermediaries

Subsection (b) of the section 104 rewrite would prohibit bribery through use of intermediaries. It replaces the "reason to know" standard of current law. In its place it makes it illegal for a domestic concern "corruptly to direct or authorize, expressly or by a course of conduct", bribery by means of a third party. Subsection (b) is intended to be the exclusive means of enforcement of the Act with respect to payments made by an agent of a "domestic concern".

Facilitating payments

Subsection (c) of the section 104 rewrite would exempt certain specified facilitating and other payments from the anti-bribery provisions. Such payments include items lawful in the country of the official, courtesies, tokens of esteem, hospitality, travel and lodging expenses, and expenses associated with the demonstration or explanation of products and customary expenditures associated with the performance of a contract.

Penalties

Subsection (d) of the section 104 rewrite would continue the civil and criminal penalties provided for in current law: $1,000,000 maximum fine for domestic concerns; for individuals a maximum fine of $10,000 and/or up to five years imprisonment.

Authority for civil injunction and investigation

Subsection (e) of the section 104 rewrite would consolidate authority to obtain injunctive relief for violation of the Act in the Department of Justice, whereas current law divides the authority between the Justice Department and the SEC. The subsection adds a provision not found in the current law authorizing the Justice Department to conduct civil investigations, and provides subpena authority for such investigations, and provides to the Attorney General rulemaking authority to implement the civil investigation provision.

"Domestic concern" and "foreign official"

Subsection (f) of the section 104 rewrite would define "domestic concern" so as to include citizens, nationals, and residents of the U.S., and companies, business entities, etc. This definition corresponds to the combination of enforcement jurisdiction under the Justice Department.

"Foreign official" would be defined so as to include officers and employees of foreign governments and agencies, political parties, party officials, and candidates.

Definitions

Section 6 defines "reasonable detail" and "reasonable assurances" in terms of "prudent individual" and cost/benefit tests.

Exclusivity provision

Section 7 provides that this Act would preclude the possibility of criminal prosecution against any person or firm alleging that the

mail or wire fraud laws have been violated as a result of a foreign corrupt payment, where the prosecution is based upon the theory that the foreign official violated a fiduciary duty.

Similarly, no prosecution for conspiracy to violate the mail or wire fraud statute based on that theory would be permissible.

Authority to issue guidelines

Section 8 would authorize the Attorney General, after consultation with the U.S. Trade Representative, the Secretary of State, the Secretary of Commerce, the Secretary of the Treasury, and representatives of the business community and the public, to issue guidelines to assist in compliance with the anti-bribery provisions. Procedures would be established for firms to request interpretative guidance from the Justice Department, with responses required to be made within thirty days. Provision would be made for the preservation of confidentiality of materials submitted for the purposes of such requests or in connection with investigations.

Annual reports

Section 8 would also call upon the Attorney General and the Chairman of the SEC to submit detailed annual public reports of their respective agency's actions taken pursuant to the Act, its views on associated problems, plans for the next fiscal year, and recommendations, if any, for amendment of the Act.

International agreements

Declares it is the Sense of the Congress that the President pursue negotiations to establish international cooperation in the prohibition of bribery. Provides for reports to the Congress on the progress of such negotiation, including suggestions for appropriate congressional action, and the consequences of potential action that can be taken under existing law to affect international cooperation for the elimination of bribery.

FISCAL IMPACT STATEMENT

No provision in S. 430 is intended by the Committee to authorize new budget authority.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 17, 1986.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN. The Congressional Budget Office has prepared the attached cost estimate for S. 430, the Business Accounting and Foreign Trade Simplification Act.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,
Sincerely,

RUDOLPH G. PENNER, *Director.*

CONGRESSIONAL BUDGET OFFICE—COST ESTIMATE

1. Bill number: S. 430.

2. Bill title: Business Accounting and Foreign Trade Simplification Act.

3. Bill status: As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, September 17, 1986.

4. Bill purpose: S. 430 would amend the Foreign Corrupt Practices Act of 1977 by revising its compliance and enforcement procedures.

5. Estimated cost to the Federal Government: While S. 430 does not specifically authorize additional appropriations, nonetheless certain costs would be incurred by federal agencies in order to implement this bill. These costs are summarized in the following table.

[By fiscal years, in millions of dollars]

	1987	1988	1989	1990	1991
Estimated authorization level	0.6	0.6	0.6	0.7	0.7
Estimated outlays	.5	.6	.6	.7	.7

The costs of this bill fall within budget function 750.

Basis of Estimate: For purposes of this estimate, it is assumed that S. 430 would be enacted around October 1, 1986. Although this bill would modify the accounting standards of the Foreign Corrupt Practices Act of 1977, the Securities and Exchange Commission [SEC] does not expect enactment of this provision to have any significant effect upon its enforcement workload.

S. 430 would also transfer from the SEC to the Department of Justice [DOJ] responsibility for enforcement of certain bribery provisions of the Act. In addition, the bill would require the DOJ to revise guidelines and procedures for compliance. Based on information provided by the DOJ and allowing for phasing-in of the new procedures, it is estimated that $0.6 million would be required in each of the fiscal years 1987, 1988, and 1989 for this purpose. It is estimated that this cost would increase to $0.7 million in each of the fiscal years 1990 and 1991. These costs would cover staff time and overhead necessary for interagency coordination, preparing guidelines and reports, assisting small businesses, and the transfer of civil enforcement authority for publicly-held corporations from the SEC to the DOJ.

6. Estimated cost to State and local government: None.

7. Estimate comparison: None.

8. Previous CBO estimate: None.

9. Estimate prepared by: Michael Sieverts.

10. Estimate approved by: James L. Blum, Assistant Director for Budget Analysis.

REGULATORY IMPACT

Pursuant to Rule XXVI, paragraph 11(b) of the rules of the Senate, the Committee has evaluated the regulatory impact of the bill and concludes that it would result in significant reduction in

unnecessary regulatory burdens associated with the Foreign Corrupt Practices Act of 1977.

The principal purpose of S. 430 is to refine and clarify the Act in order to reduce the burden of compliance without undermining the purpose of the Act. By amending the Act to provide more certainty about its meaning, the Committee expects to reduce substantially the costs associated with compliance.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirements of Section 4 of Rule XXIX of the Standing Rules of the Senate in order to expedite the business of the Senate.

ADDITIONAL VIEWS OF SENATOR PROXMIRE ON S. 430

Despite the good intentions of its sponsors, S. 430 does not simply clarify the original intent of the Foreign Corrupt Practices Act [FCPA]. Instead, it would gut the FCPA and help to bring back bribery. Let me explain.

WHY THE FCPA WAS ENACTED

The Congress unanimously passed the FCPA in 1977 in response to revelations about the worst domestic and foreign bribery scandals in American corporate history.

Beginning in 1973, as a result of the role of the Watergate Special Prosecutor, it became clear that many corporations had made substantial, illegal political contributions to the notorious CREEP, that is the Committee to Re-elect President Nixon in 1972. The secret contributions were made possible by the off-the-books slush funds being maintained by many of America's preeminent corporations. A subsequent SEC investigation into such corporate slush funds revealed that instances of undisclosed, questionable or illegal corporate payments, both domestic and foreign, were widespread. In 1975 the SEC announced a program whereby companies could voluntarily disclose questionable activities without penalty. Under this program more than 450 corporations admitted making very questionable or outright illegal payments exceeding $300 million.

These revelations demonstrated that there were real shortcomings in our Government's ability to police the illegal use of corporate funds by the management of our corporations. In fact it was revealed that top management often did not know how their own corporation's funds were being used. Boards of directors of bribing corporations often pleaded ignorance about the misuse of corporate funds they were responsible for.

In March 1976, just a little over 10 years ago, President Ford established a Cabinet-level task force to examine the problem of corporate bribes to win sales. In doing so he said:

> Corrupt business practices strike at the very heart of our own moral code, and our faith in free enterprise * * * as to American corporations the United States bears a clear responsibility to bring such practices to a halt.

The SEC's formal report to Congress in 1976 on questionable payments stated:

> The most devastating disclosure that we have uncovered in our recent experience with illegal or questionable payments has been the fact that, and the extent to which, some companies have falsified entries on their own books and records.

The SEC subsequently stated that illegal payments and falsifications of books were made possible because internal corporate accounting controls were ineffective or easily subverted.

Follow up investigations in 1976 and 1977 revealed that American corporations not only made questionable payments at home, but were also doing so abroad to win sales and increase profits in countries such as the Netherlands, Japan, Iran, France, Germany, Saudi Arabia, Brazil, Malaysia, and Taiwan. During our hearings on the Foreign Corrupt Practices Act we in Congress concluded that corrupt payments to foreign officials caused serious damage to America's national interests in critical areas of the world. Lockheed Corporation's payment of $1.6 million to Prime Minister Tanaka of Japan caused the latter's resignation and later his criminal conviction. Allegations about Lockheed payments to Prince Bernhard of the Netherlands almost caused the monarchy to collapse in that country. Exxon's payments of more than $50 million to Italian political candidates resulted in a scandal that brought substantial election gains to the Communist Party in Italy. A 1977 House report stated that alleged payments to officials of the Italian Government, "eroded public support for that government and jeopardized U.S. foreign policy, not only with respect to Italy and the Mediterranean area, but with respect to the entire NATO alliance as well."

The question before the Congress in 1977 was whether we should permit some dishonest corporations to harm our foreign policy interests in their zeal for sales and profits. We answered "No" unanimously. Congress considered then that bribes are bad business because they distort free markets. Goods should be sold on the basis of price, quality, and service—not on the basis of bribes. We also concluded bribes were bad politically as they undermine confidence in America's integrity and corrupted other governments, including the developing democratic institutions in the Third World. Congress in 1977 found no country where bribing officials to win sales was not against the law. So the defense that bribes were a way of life in some countries—did not mean the people of those countries wanted such behavior to be the norm. Just as Americans do not want foreign corporations bribing our officials—so do people in other countries present such practices by our corporations in their countries.

Mr. David Newsome, a former career diplomat who became an ambassador and Under Secretary of State for Political Affairs, has testified in the House on proposed amendments to the FCPA. He said he had personally seen revolutions detrimental to United States interests take place in both Iraq and Libya. In both cases, he said, "the degree of corruption in the regime was a factor in the loss of public confidence that made a successful revolution possible". Look at the cost to America today of the revolution in Libya that brought Colonel Qaddafi to power. It demonstrates that in considering whether the FCPA causes our companies to lose business we should not imagine that there are not long-term costs to permitting our companies to make bribes in order to win sales. No, the ultimate costs of such corruption can later come back to haunt us as they have done in spades in Libya and Iran. Is it really in our national interest to allow American corporations to contribute to

corrupting the officials of foreign governments in order to win a few more sales? In 1977 everyone in Congress said, "No"—I hope this Congress will not reverse that judgment.

IMPACT ON SALES

That raises another issue. Does the FCPA's prohibition on bribery itself contribute to our massive trade deficit? Knowledgeable witnesses in 1977 testified that corporate bribery was not needed to win sales abroad. Many of our most reputable corporations never engaged in the practice. It was revealed that agents and other intermediaries often never even passed on to foreign officials the bribes our corporations thought were part of getting a sale. It was found in some cases that firms were being "ripped off" by their own employees under the guise of paying bribes to foreign officials.

If the FCPA did have a "chilling effect" on U.S. exports as the proponents of S. 430 allege, we would expect to find a measurable drop in exports immediately following the passage of the Act when the alleged "chilling effect" might be expected to have its maximum impact. What are the facts? In the 3 years preceding the passage of the FCPA, U.S. exports (adjusted for inflation) grew at an annual rate of 1.4 percent a year. In the 3 years immediately after the passage of the FCPA, U.S. exports grew at an annual rate of 12.5 percent, a more than 8 times the growth rate of the 3 preceding years! If we are to form any conclusion about the impact of the FCPA on U.S. exports, the record indicates it has been immensely favorable.

A 1981 study by the GAO on the FCPA that was based on an actual survey of 250 corporations revealed that most corporations said the enactment of the FCPA had little or no effect on their business. An article in the winter 1984 edition of the Journal of International Business Studies by assistant prof. John Graham of the University of Southern California's School of Business confirms this. The article, entitled "The Foreign Corrupt Practices Act: A New Perspective" uses published trade statistics and other Government reports to demonstrate that the FCPA was found to have no negative effect on the export performance of American industry. It is important to note by way of contrast that the proponents of S. 430 have not been able to produce any credible evidence, other than unsupported claims by some companies, that the FCPA harms the export performance of American corporations.

HAS THE FCPA BEEN A SUCCESS

The FCPA attempted to deal squarely with the breakdown in management control over corporate assets by requiring companies to maintain both accurate business records and effective internal accounting control systems. The Act made clear that neither business records nor the accounting system had to be perfect, as a reasonableness standard was incorporated into both. The FCPA also made it illegal for a company to bribe a foreign government official either directly or through a sales agent where the company "knew or had reason to know" that all or a part of the payment to the agent would be passed on to the foreign government official.

The FCPA is a good law. The evidence indicates that it has stopped slush fund bookkeeping by American companies and has stopped corruption of foreign government officials by U.S. corporations. Despite this, since 1981 a vocal band of trade lobbyists have pushed for the enactment of legislation, like S. 430, which will emasculate the FCPA. It is claimed that S. 430 will not reverse the original judgment of Congress that forthrightly condemned bribery as a means of winning foreign sales. Rather it is contended that the FCPA needs to be amended to clarify certain ambiguities in the present law. It is true that when the FCPA was first enacted in 1977 there were questions about the meaning of certain concepts in the Act and about how they would be enforced. That is normal when a new law is passed and was doubly true for the FCPA because America for the first time was regulating the conduct of its companies overseas insofar as bribery was concerned. Interpretative statements by the SEC and the Justice Department about their enforcement policies have long since quieted such concerns.

Mr. Arthur Mathews, a corporate defense lawyer, a former SEC official and a partner with the prestigious Washington law firm of Wilmer, Cutler, and Pickering, testified on that point at our June 10 hearing on S. 430. He said, among other things, that he would counsel the Congress, "to continue a very careful analysis of the underlying policy considerations before tinkering with a statute as effective as the FCPA has been". He noted that there was little concern in today's corporate world about the FCPA. "There was," he said, "a great deal of concern in the first few years after the FCPA became effective, but it is very seldom that lawyers get calls today asking their advice on the ambiguity of the foreign bribery provisions or the other provisions."

So if the so-called ambiguity of the FCPA is no longer a problem, why is there such an effort by some to change the FCPA? Let me explain why I believe portions of the present law would in fact be gutted by S. 430.

THE ACCOUNTING PROVISIONS

The 1977 Act's accounting provisions merely codify a basic and uncontroversial management principle: No enterprise of any size can operate successfully without maintaining control over its transactions and the disposition of its assets. It seeks to stop corporate officials from building "off the books" slush funds that are then used for illegal purposes both at home and abroad. The 1977 Act does this through two inter-related accounting requirements: First, public companies are required to "make and keep books, records, and accounts which in reasonable detail accurately and fairly reflect the transactions and dispositions" of their assets. Second corporations are also required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that certain specified objectives are attained. In essence these objectives are that assets be safeguarded from unauthorized use, that corporate transaction conform to managerial authorization, and that records be accurate. The majority report contends the changes S. 430 makes in these provisions are justified because they "have proven to be overly burdensome requirements which

have caused businesses to incur costs substantially in excess of the benefits derived from these expenditures." In rejecting this rationale for changing these provisions I note that our 1977 Committee report stated that the "Committee recognizes that management must necessarily estimate and evaluate the cost-benefit relationships of the steps to be taken under this section". So the cost/benefit rationale for changing the accounting provisions does not hold water.

The proponents of S. 430 also claim that the FCPA's accounting provisions are ambiguous and expose corporate officials to civil and even criminal enforcement actions because of minor technical errors in corporate books, or because of weaknesses in corporate accounting controls. I don't know how people can make this claim with a straight face. During the Carter administration the SEC adopted a statement of policy that is still in effect today. The Commission announced that it would not bring a single case under the FCPA's accounting provisions that did not also involve other violations of law. It also stated that "a criminal prosecution would be recommended to the Justice Department for violations of the FCPA's accounting provisions only in the most serious and egregious cases." In all of our hearings on changes to the FCPA no one ever asserted that any enforcement actions brought by the SEC or Justice Department were unwarranted. Despite this we find the proponents of S. 430 attempting to justify their removal of criminal penalties for violations of the FCPA's accounting provisions on the basis that corporate managers are concerned with being prosecuted for technical violations of the Act's accounting provisions. It is contended such unwarranted concerns justify removing criminal penalties for deliberate, calculated, knowing violations by a company's management of its legal duty to have an accounting system in place that prevents the building of off-the-books slush funds and makes the corporation keep honest books and records. Mr. Arthur Mathews, the expert corporate criminal defense lawyer who I mentioned above, said at our June 10, 1986, hearing on S. 430 that, "it makes no sense not to provide a criminal penalty for knowing violations of the statute."

Mr. Mathews also testified that "the books and records provision of the FCPA has had a more significant effect on corporate accountability than any statutory provision that I have seen in my 25 years or so of law practice". He warned that other changes to the accounting provisions of the FCPA incorporated in S. 430 "would allow corporate officials or employees to falsify books and records, thereby concealing the true nature and purpose of corporate transactions, so long as the result of such falsification is not material to the company's financial statement nor contrary to management's general or specific authorization." He said the changes S. 430 makes in the FCPA's accounting provisions "would be detrimental to the public."

Let me give some additional reasons why I believe Mr. Mathews is right on target. The majority report states that "the purpose of the FCPA accounting provisions was to proscribe knowing conduct, not unknowing conduct. Accordingly the bill provides that violations only occur where a person knowingly violates Section 13(b)(2)." A very serious problem is raised by the interpretation of

the term "knowing" in the majority report. It states that enforcement of the civil violations of the Act's accounting provisions is only available where there is a "conscious awareness" of a violation of wrongdoing beyond negligence. The majority report's interpretation of "knowing" would thus engraft an element of intent on the civil sanctions under the statute that would for all practical purposes ensure that many serious violations of the FCPA's accounting provisions would not be enforced. While an intentional standard is appropriate for criminal prosecutions, it is wholly inappropriate to civil enforcement. The removal of criminal penalties along with the adoption of an intentional standard for civil violations will enfeeble the enforcement of the FCPA's accounting standards. Slush funds might be established in violation of the section, but senior management could escape responsibility by claiming they did not "know." Furthermore the majority report's contention that outside auditors will act as insurers of accurate recordkeeping is not well placed. The obligation is on the corporation to maintain accurate books on its own. The outside auditors did not stop corporations from creating "off-the-books slush funds" prior to the FCPA's enactment. They are no substitute for requiring corporations to have effective accounting systems that ensure accurate books and records are maintained, and to having an enforceable statute to penalize them civilly and in egregious cases even criminally if they do not.

THE REASON TO KNOW STANDARD

The FCPA prohibits payments to agents where a company "knows or has reason to know" that all or a portion of the payment will be passed on to a foreign government official. S. 430 eliminates this standard. Instead S. 430 proscribes only payments to officials through agents directed or authorized by a company "expressly or by a course of conduct." The original bill to amend the FCPA called for a "direct or authorize" standard in place of the "reason to know." Here is what a number of key witnesses said about the "direct or authorize" standard at hearings the Banking Committee held on that proposal.

Harold Williams (former Chairman of the SEC):

> I am concerned with the pending bill's deletion of the reason to know standard from the Act. If enacted with this deletion, it would be possible for management to adopt the "shut eyed" approach whereby liability would be avoided by remaining oblivious to the actual facts and circumstances underlying the subject transactions. Further, it would encourage a form of managerial irresponsibility that should not be the underlying effect of federal legislation and would give rise to an environment of do what you need to do, just don't tell me.

Ted Sorenson (former Assistant to President Kennedy) in speaking of the "direct or authorize" standard said:

> Surely that invites a wide-open return to the knowing wink and the pregnant nod by not including those who knowingly aid or abet such payments.

Philip B. Heymann (former Assistant Attorney General, Criminal Division, Justice Department):

> I think the language of authorize or direct will allow the business of bagmen to flourish. The language which holds the corporation responsible only if it authorized or directed—I think they never do, never did, and never will authorize and direct at a high level of the corporation. And yet, bribes did go on, and therefore, I fear will go on again.

The majority report tells us that we have to make a change in the FCPA because "ambiguities involved in this provision have caused some legal commentators and cautious legal counsel to equate 'reason to know' with 'reason to suspect'." The fact of the matter is that there are numerous other Federal criminal statutes that likewise utilize a "reason to know" standard. See, for example 18 U.S.C. sections 1384, 2251, 2423 or 50 U.S.C. 783. The standard has withstood numerous court challenges from those who sought to escape prosecution by claiming "reason to know" is ambiguous and unconstitutionally vague. See, for example, *United States* v. *Banks* 368 F. Supp. 1245 (1973); *United States* v. *Mechanic* 454 F. 2d 849 (1971); *United States* v. *Featherston* 461 F. 2d 1119 (1972).

Mr. John C. Keeney, the Deputy Assistant Attorney General of the Justice Department's Criminal Division said at a June 10 hearing that the "reason to know" standard has never been abused. Under that standard, he said, "The policy of the Justice Department has been to prosecute only those cases here the evidence of awareness, whether direct or circumstantial, was so clear as to constitute actual knowledge of the bribe scheme." No witness at any of our hearings ever brought to our attention any prosecution under the "reason to know" standard that was unjust. So why change it?

Certainly adding the term "expressly" to the "direct or authorize" standard makes it more difficult to enforce as it requires a prosecutor to provide express direction or authorization of illegal payments by management. But how is the term "course of conduct" which was added to give prosecutors some help in proving knowledge by management to be interpreted? Does knowledge that an agent would pay a bribe on behalf of the company satisfy the course of conduct standard? The majority report says nothing on the issue. Does that indicate that knowledge of what an agent would do is or is not intended to be actionable? What if a reasonable person in the circumstances should have known that a bribe would be paid? Is an excessive payment made to an agent, in reckless disregard of that fact, by a company where a bribe was subsequently paid subject to an enforcement action? Again, the majority report is silent. I do welcome the statement in the majority report, that the "direct or authorize expressly or by a course of conduct" is intended to apply to foreign cases the enforcement standard that applies to domestic bribery. This means the new standard is meant to cover conspiracy and liability for the acts of an agent within his scope of employment. As Philip B. Heymann, the former Assistant Attorney General in charge of the Criminal Division of the Justice Department, said before the Committee in testimony in 1981 "A corporation is responsible when one of its agents pays a bribe in furtherance of his own marketing activity. There is no requirement

under normal law that anybody such as the board of directors, the Chairman of the Board, the president, the vice-president, the executive committee approve, authorize direct, the bribe." Nevertheless I am troubled that under the majority report language of S. 430, there is a risk that some cases may go unpunished where bribes are paid but astute counsel makes sure that even though the company knew or had reason to know of bribes it did not direct or authorize them expressly or by course of conduct. I see no need to make a change from the present statute's "reason to know" standard.

FACILITATING PAYMENT EXCEPTIONS

S. 430 contains five exceptions to the FCPA's prohibition on paying bribes. It is alleged that these exceptions are needed to allow for facilitating payments, sometimes called grease payments, that are needed to get minor officials of foreign governments to carry out their nondiscretionary duties. The present FCPA already allows for grease payments. The Banking Committee report on the 1977 bill which became our current law states:

> The statute covers payments made to foreign officials for the purpose of obtaining business or influencing legislation or regulations. The statute does not, therefor cover so-called "grease" payments such as payments for expediting shipments through customs, or placing a transatlantic telephone call, securing required permits, or obtaining adequate police protection, transactions which may involve even the proper performance of duties.

The House Committee on Interstate and Foreign Commerce in its report on the bill which became the FCPA said:

> The language of the bill is deliberately cast in terms which differentiate between such payments and facilitating payments, sometimes called "grease payments". In using the word "corruptly", the committee intends to distinguish between payments which cause an official to exercise other than his free will in acting or deciding or influencing an act or decision and those payments which merely move a particular matter toward an eventual act or decision or which do not involve any discretionary action. In defining "foreign official", the committee emphasizes this crucial distinction by excluding from the definition of "foreign official" government employees whose duties are essentially ministerial or clerical.
>
> For example, a gratuity paid to a customs official to speed the processing of a customs document would not be reached by the bill. Nor would it reach payments made to secure permits, licenses, or the expeditious performance of similar duties of an essentially ministerial or clerical nature which must of necessity be performed in any event.
>
> While payments made to assure or to speed the proper performance of a foreign official's duties may be reprehensible in the United States, the committee recognizes that they are not necessarily so viewed elsewhere in the world

> and that it is not feasible for the United States to attempt unilaterally to eradicate all such payments. As a result, the committee has not attempted to reach such payments. However, where the payment is made to influence the passage of law, regulations, the placement of government contracts, the formulation of policy or other discretionary governmental functions, such payments would be prohibited.

If, as I have just shown, the present FCPA already permits "grease payments" why does S. 430 include five new exceptions to the prohibition on bribery to permit grease payments. Is it really wise public policy to adopt these exceptions if in reality they gut the FCPA's prohibition on foreign bribery? Let me explain why I am concerned. S. 430 sets forth these five exceptions:

> (1) Facilitating or expediting payments to a foreign official, the purpose of which is to expedite or secure the performance of a routine governmental action by a foreign official;
>
> (2) Items lawful under the laws of the foreign official's country;
>
> (3) Items which constitute a courtesy, or a token of regard, or esteem, or in return for hospitality;
>
> (4) Expenditures, including travel and lodging expenses, associated with the selling or purchase of goods or services or with the demonstration or explanation of products;
>
> (5) Ordinary expenditures, including travel and lodging expenses, associated with the performance of a contract.

Mr. Keeney of the Department of Justice's Criminal Division noted problems with each of these five exceptions at our June 10 hearing on S. 430. He said of exception one that, "we must take care to ensure that routine governmental action is defined carefully so that what is and is not permitted is well understood". Presently it appears to me that "routine governmental action" could in some countries involve awarding contracts. The term needs to be defined with precision in the statute. Of exception two Mr. Keeney said, "To the extent the Banking Committee deems an exception necessary, we think it should be in the form of an affirmative defense." He noted with regard to exception three that is "payments which regard a courtesy or a token of regard or esteem" the language needs to be clarified to ensure it covers only payments of nominal value. Of the final two exceptions Keeney said the Justice Department believes language is needed to clarify that "both of these exceptions are intended to be applied only in situations involving legitimate, bona fide, and reasonable expenditures made to or for the foreign official in payment for or reimbursement of that foreign official's expenses only."

Not one of Mr. Keeney's recommendations are incorporated into the bill reported out by the Banking Committee. S. 430 appears today exactly as it appeared prior to our June 10 hearing.

I asked Mr. Keeney at that hearing if he would be against the enactment of S. 430 if his recommendations were not adopted. He said:

> If our amendments are accepted, we believe that we have a viable FCPA statute. I'd have to think about it if certain of the amendments were not accepted.

I asked Mr. Mathews, the former SEC lawyer now with Wilmer, Cutler, and Pickering, who also testified whether he agreed with the lawyer who testified in the House that certain of the "grease payment" exceptions created a loophole through which you could drive a truck. Mr. Mathews stated in reply:

> I would on the grease payment or facilitating payment provisions, unless they are at least modified along the lines that the Department of Justice recommended. I think they constitute a major loophole.

The New York Times in a 1983 editorial on a bill identical to S. 430, said the facilitating payments exception contained loopholes for bribery "big enough to fly all of Lockheed through." I agree.

OMISSION OF AGENTS FROM FCPA PROSECUTION

Another provision of S. 430 that weakens the Government's ability to stop bribery as a means of winning sales is section 104. That section omits agents from the Act's coverage. The Department of Justice at our June 10, 1986, hearing on S. 430 recommended that the Congress retain agents within the FCPA's coverage because "to eliminate them from coverage would decrease the Act's effectiveness." Mr. John Keeney of Justice's Criminal Division testified that:

> The majority of the FCPA cases which have been investigated involved payments made to "agents" or "consultants" who then forwarded all or a portion of the money they received to foreign officials. Although many of these "agents" or "consultants" were nationals of the foreign country whose officials were to be bribed, others were American citizens residing either in the foreign country or in the United States.
>
> Retaining agents within the coverage of the Act specifically would accomplish three goals. First, it would give a clear warning to those who fall within this group that their actions have not been removed from scrutiny. Second, it would prevent courts from construing this section as not including agents. As will be discussed later, the present FCPA has been construed very narrowly and literally by the courts. Finally, it would maintain for the Department an effective investigative tool. We have found that some foreign governments are more willing to cooperate and to share evidence with the United States when we can show them evidence that their own citizens are violating the laws of the United States as well as of their own country. Without such mutual assistance, foreign bribery violations are often impossible to prove. Removing this impetus for cooperation would hamper the already difficult investigative task of prosecuting such activity effectively.

I have not heard even one justification for removing agents from being prosecuted for FCPA violations. The majority report offers none. Neither does it even mention the very strong testimony from the Justice Department to keep agents within the Act's coverage. In my view it would be a mistake to take away from Justice its

present authority to prosecute agents. Oftentimes in criminal prosecutions you only get to the top persons involved in a criminal activity by being able to prosecute the "go-fors" who will then agree to testify about the higher-ups in return for leniency. That is exactly how the Watergate conspiracy was cracked. So why is S. 430 removing the government's ability to prosecute "agents" or "go-fors" despite the specific recommendation of the Justice Department not to do so? No explanation is offered in the majority report.

CONCLUSION

There are still other provisions of S. 430 that further weaken the government's ability to stop bribery as a means of winning sales. For example, the Justice Department testified against a provision of the bill which prohibits it from ever using the mail or wire fraud statutes to prosecute foreign bribery. The Department recommended that provision be amended to provide such statutes could be used in cases where Justice finds it cannot effectively prosecute under the FCPA. S. 430 takes no heed of that recommendation. Why?

I have explained my concerns about S. 430 at some length because I want to demonstrate my belief, that it is a seriously flawed bill, is based on facts. I hope the Senate will subject S. 430 to the most serious scrutiny before acting on the bill. If it does, I am convinced it will reject this legislation which will viscerate the effectiveness of our antibribery law, the FCPA.

WILLIAM PROXMIRE.

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99TH CONGRESS
2d Session

SENATE

REPORT
99-490

SECOND MONETARY POLICY REPORT FOR 1986

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

SEPTEMBER 26 (legislative day, SEPTEMBER 24), 1986.—Ordered to be printed.

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, September 26, 1986.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1986 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearing held on July 23, 1986.

Sincerely yours,

JAKE GARN, *Chairman.*

CONTENTS

	Page
Letter of transmittal	III
Second monetary policy report for 1986	1
Monetary aggregates and velocity	1
Inflation and interest rates	2
GNP and employment	3
Trade	4
Conclusions	4
Additional views of:	
Mr. Proxmire	6
Mr. Riegle	8

ADDITIONAL MATERIAL FOR THE RECORD

"Financial Transactions and the Rapid Rise of the Money Stock," article by Paul D. Mastroddi, assistant economist from Morgan Guaranty Trust Co	9

99TH CONGRESS
2d Session

SENATE

REPORT
99-490

SECOND MONETARY POLICY REPORT FOR 1986

SEPTEMBER 26 (legislative day SEPTEMBER 24), 1986.—Ordered to be printed

Mr. HEINZ (for Mr. GARN), from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Submitted pursuant to Public Law 95-523]

SECOND MONETARY POLICY REPORT FOR 1986

On July 18, 1986, the Committee on Banking, Housing, and Urban Affairs received this year's second "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

On July 23, 1986, Federal Reserve Board Chairman Paul A. Volcker, testified before the Banking Committee on the conduct of monetary policy during the first half of 1986 and on the Federal Reserve's monetary policy objectives during the remainder of 1986 and in 1987.

MONETARY AGGREGATES AND VELOCITY

When Chairman Volcker appeared before the Banking Committee in February, he announced that the Fed's 1986 target growth ranges for the monetary aggregates would be 3 to 8 percent for M1 and 6 to 9 percent for M2 and M3. He also announced a "monitoring" range of 8 to 11 percent for the credit market debt of domestic nonfinancial sectors.

Through August, using the fourth quarter of 1985 as a base, M1 actually grew at an annual rate of 14.4 percent, M2 at 8.9 percent and M3 at 9.0 percent. Through July, debt grew at 12.6 percent.

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When the Fed Chairman appeared before the Committee in July, M1 had been growing at an annual rate of 12¾ percent since the first of the year, already well in excess of the upper boundary of its target range. M2 and M3, on the other hand, had been growing at 7.8 percent, near the middle of their target ranges. Debt had been growing at 12.7 percent, somewhat above the upper boundary of its "monitoring" range.

According to the "Monetary Policy Report," through June, "* * * monetary policy basically * * * accommodated strong demands for reserves to back deposits." During this period, M1 velocity declined at a rate faster than the postwar record decline of 1985.

The report pointed to lower interest rates in seeking to explain the sharp decline in M1 velocity: With lower rates, NOW accounts become more competitive as repositories for savings, and the opportunity costs to businesses of holding demand deposits decline. The report concluded, however, that, "Even after taking account of these factors * * * the strength of M1 appeared extraordinary in the first half."

A paper submitted to the Committee by the economics department of The Morgan Bank suggests an additional factor behind the decline in velocity. As pointed out by the Morgan paper, velocity relates the demand for money balances to spending, and it is usually measured by dividing the money supply into GNP. This methodology implicitly uses GNP as a proxy for total spending in the economy.

But if total spending in the economy is increasing faster than GNP because of some factor such as a rapid rise in financial transactions, even if the demand for money relative to spending remains approximately constant, measuring velocity by dividing the money supply into GNP will give a misleading indication that overall velocity has fallen.

Chairman Volcker told the Banking Committee in July that the Fed had not restricted the availability of reserves to the banking system during the first half of the year in an effort to keep M1 growth within its target range because: (1) M2 and M3 were not growing excessively, (2) the growth in M1 appeared to reflect merely a "shifting of the composition of liquid assets," and (3) there was no evidence of mounting inflationary pressures or of accelerating economic growth.

For the remainder of 1986, the Fed Chairman told the Committee that, given the "uncertainties as to the behavior" of M1, the aggregate's target range would not be "recalibrated" and that the existing 6 to 9 percent ranges for M2 and M3 would be retained. For 1987, the Chairman announced "tentative" decisions to maintain the 3-to-8 percent target range for M1 growth and lower the target ranges for M2 and M3 to 5.5 to 8.5 percent.

INFLATION AND INTEREST RATES

Inflation remains far below the double-digit rates prevailing at the beginning of the decade. For the 12 months ending in August, the Consumer Price Index for all urban consumers rose just 1.6 percent. For the 12 months ending in July, producer prices actually declined 2.3 percent.

These numbers, however, somewhat overstate the progress that has been made against inflation because they are heavily influenced by energy and food prices that have been highly erratic. Excluding energy and food, consumer prices are up 4.1 percent over the year and producer prices are up 2.1 percent.

Interest rates also are far below the levels prevailing early in the decade. From an average of 15.14 percent in 1982, new home mortgage yields had fallen to 10.14 percent in June. Since the last monetary policy hearing, the Federal Reserve has cut the discount rate three times, to 6.5 percent in April, to 6.0 percent in July and to 5.5 percent in August. The prime rate has fallen from 9.5 percent at the beginning of the year to 7.5 percent.

GNP AND EMPLOYMENT

The current economic expansion is now 46 months old. This compares with an average life of 33 months for the five previous peacetime expansions.

After growing 3.6 percent in 1983 and 6.4 percent in 1984, real gross national product slowed its growth rate to 2.7 percent last year. During the first half of 1986, real GNP growth continued at a 2.2-percent annual rate.

Employment data also continue to reflect an expanding economy. In August, the unemployment rate for civilian workers fell to 6.8 percent, and the unemployment rate for all workers fell to 6.7 percent. Both indices have now declined for 3 months in a row. Moreover, the employment ratio—the percent of the civilian working-age population that is employed—continues to set new records.

Personal consumption expenditures recently have provided the major stimulus to the economic expansion. In 1985, personal consumption expenditures rose 3.5 percent in real terms, compared to a 2.7-percent increase in real GNP. Even in the second quarter of this year when real growth slowed to 0.6 percent rate, personal consumption expenditures rose at an annual rate of 6.5 percent.

Housing has provided strong support to the economic expansion since the beginning of the decline in mortgage rates after 1982. Housing starts exceeded 1.7 million units in 1983, 1984, and 1985. Starts have exceeded the 1.8 million unit level every month since last December.

Nonresidential fixed investment provided important stimulus earlier in the expansion, rising 16.9 percent and 9.3 percent in real terms during 1984 and 1985 respectively, but capital spending declined in the first two quarters of 1986. The reasons for the declines are varied. Some of the capital spending that might otherwise have occurred this year was accelerated to 1985 in anticipation that tax revision would reduce investment tax credits and/or lengthen depreciation schedules for investments made after the first of the year.

The drop in oil prices earlier this year led to sharp reductions in capital spending by the energy industry which normally accounts for 7 to 10 pecent of all purchases of capital goods. While capital spending continues on projects designed to enhance productivity, there is limited incentive to expand with factories operating at only about 78 percent of capacity.

Inventory investment made a major contribution to the economic expansion in 1984, and a slowdown in inventory accumulation was a major factor in the slowing of GNP growth in 1985. A similar reduction in the rate of inventory investment contributed to the slowing of economic growth between the first and second quarters of this year: After growing at an annual rate of $39.9 billion in the first quarter, inventory investment slowed to an annual rate of only $19.6 billion in the April/June quarter. Still, the ratio of inventories to final sales remains low, and any pickup in final sales can be expected to lead to increased inventory investment.

TRADE

Net exports have been a growing drag on the economic expansion. The value of net exports declined from minus $6.1 billion in 1983 to minus $58.7 billion in 1984 to minus $78.9 billion in 1985. During the second quarter of this year, net exports were running at an annual rate of minus $100.2 billion.

Part of the problem with net exports was the sharp rise in the value of the dollar after 1980, but considerable progress has been made toward bringing the dollar's value down to more realistic levels in trade terms. Since its peak in February of 1985, the trade-weighted value of the dollar has declined about 28 percent. Just since the beginning of 1986, the currency's trade weighted-value has declined by about 11 percent.

When a currency declines in value, the initial effect is to raise the price and value of imports while lowering the value of exports. Only after time do the real quantities of imports and exports adjust. This "J-curve" effect is partly responsible for the persistence of U.S. trade and current account deficits in the face of a declining dollar.

Other factors, however, are also responsible. Real interest rates in the United States are higher than they otherwise would be without the continuing large Federal budget deficits. These interest rates draw capital into the United States and lead to larger surpluses on the balance-of-payments capital accounts. Surpluses on the capital accounts must be offset by deficits on the trade and current accounts.

Other industrialized countries, Japan and West Germany in particular, have relied too much on the United States to provide the engine for economic growth. As a result their industries have concentrated on marketing in the United States and U.S. producers have been hampered in their efforts to expand exports.

While the United States dollar has appreciated against the currencies of such major trading partners as West Germany and Japan, the dollar has not appreciated against the currencies of other countries, like Taiwan and South Korea, that run large trade surpluses with the United States. Finally, many of the U.S. major trading partners continue to maintain barriers against American goods entering their economies.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on

Banking, Housing, and Urban Affairs stating its views and recommendations regarding the Federal Reserve's monetary policy report; the Committee finds:

(1) While a dynamic economy like the U.S. will always have problems that need addressing (such as the current budget and trade deficits), sight should not be lost of the impressive economic achievements of recent years. The United States has sustained an economic expansion that now ranks are one of the longest of the postwar era. The employment ratio—the percent of the civilian working-age population that is employed—continues to set new records. At the same time, inflation and interest rates have been reduced sharply.

(2) Rapid M1 money growth since late in 1984 has not led to the surge in the rate of real GNP growth or in the rate of inflation that the economic history of the postwar period would have suggested. In part, the failure of GNP growth and inflation to accelerate appears to have been the result of leakage of aggregate demand into imports and to an increase in the demand for money associated with lower interest rates, new deposit instruments and rapid growth in spending on items not included in GNP. Declining energy prices also played a part in holding down inflationary pressures.

If the Federal Reserve had pursued a policy of trying to keep M1 growth within the previously announced target growth ranges during the first half of this year, it would have been necessary to sharply restrict the availability of reserves to depository institutions, and this would have pushed up interest rates. Such a policy would have been unwise: (a) given the lack of any evidence of a buildup of inflationary pressures, (b) given the threat that higher interest rates would have posed to the economic expansion that already was relatively old by postwar standards and was experiencing a slowdown in the second quarter, (c) given the fact that M2 and M3 were continuing to grow at rates comfortably within their target growth ranges, and (d) given the reasons to believe that the growth in M1 was needed to offset a continuing decline in velocity.

(4) Since the current economic expansion already is long-lived by postwar standards and the rate of real growth in GNP has slowed recently, some additional easing of monetary policy, possibly including a further cut in the discount rate, may be appropriate. Once velocity stops delcining, however, money growth will need to be slowed to avoid a reemergence of inflationary pressures. The decision of the Federal Reserve to reduce the upper and lower boundaries of the 1987 money growth targets for M2 and M3 is an appropriate signal to recognize that money growth will need to be slowed over time.

(5) The decline in the value of the dollar since early 1985 should help reduce the drag on the U.S. economy from net exports. The decline in the dollar's value, however, needs to be supplemented by our major trading partners in the industrialized world providing additional stimulus to their domestic economies and opening their economies to more U.S. exports. It may also be necessary for the currencies of other countries with large external surpluses to rise against the dollar.

ADDITIONAL VIEWS OF MR. PROXMIRE

I do not agree with the majority report's rosy assessment of our economic condition nor with its conclusion that the Federal Reserve has been following about the right monetary policy. In fact, the Fed's policy has been highly expansionary and, if continued, will threaten to rekindle the fires of inflation.

Politicians tend to have conveniently short memories. Many of us in Washington have apparently forgotten the loose money policies of the 1970's that led to double digit inflation and sky-high interest rates. Now that inflation seems to be under control, many have urged a return to the mistaken belief that the Federal Reserve can somehow permanently spur economic growth by inflating the money supply. Indeed, even the Federal Reserve, perhaps under pressure from the Reagan "gang of four," seems to have relaxed its vigilance on inflation and has been tilting toward the discredited easy money policies of the 1970's that almost wrecked the economy.

By any measure, monetary policy has been extraordinarily expansive over the last 6 months. The money supply as defined by M1 grew at an annual rate of 17.9 percent, or more than twice its upper target. Apologists for excessive money growth argue that there has been a breakdown in the link between M1 and GNP because of financial deregulation. For example, with the decline in interest rates, it is argued that many people shift cash from savings accounts into interest bearing NOW accounts which are now included in the definition of M1. Yet even noninterest bearing demand deposits grew by 16.6 percent during this same period. Clearly most of the growth in M1 is not due to a sudden increase in the demand of the public for more cash balances but rather the willingness of the Fed to supply more dollars in a misguided effort to keep the economy recovery going.

Other measures of the money supply show a similar pattern. M2 grew at an annual rate of 11.2 percent over the last 6 months, or more than 2 percentage points over its upper target. Likewise, M3 grew by 9.7 percent, exceeding its upper target of 9 percent. Sooner or later this excessive growth in money will reflect itself in higher prices.

There is growing evidence that financial markets are also beginning to conclude that we are headed for a revival of inflation. During the last month, interest rates on long-term government bonds increased by over two-thirds of a percentage point. Of course, long-term interest rates are strongly influenced by inflationary expectations. It is little wonder that the fear of inflation is beginning to become a significant factor again given the explosive growth in money.

While the current figures on inflation look good, there is ample evidence that inflation is by no means licked. The sharp drop in

the exchange value of the dollar will eventually begin to exert upward pressure on inflation as foreign producers raise their prices and domestic producers follow suit. Likewise, the persistent drop in the price of oil has about run its course and will inevitably begin to reverse itself. Most importantly, the President and the Congress have made virtually no progress on reducing our colossal budget deficit despite the promises made under Gramm-Rudman.

Another troubling element is the persistent pressure from the Treasury and the White House on the Federal Reserve to boost the economy through excessive money growth. Indeed, an article by Eric Heinemann in the August 11 American Banker quotes a former insider in the Reagan administration to the effect that the White House has an unannounced goal of an increase in consumer prices of 6 to 7 percent. "Disinflation is just too costly, too painful for them to tolerate" this former Reagan official is reported to have said.

As I view the economic outlook, there is little the Federal Reserve can do in a positive sense to boost the rate of economic growth over the next few months without running a serious risk of reigniting inflation. In that case, all of the painful gains made over the last several years would have been wasted. If we have learned anything it is that we cannot fine tune the economy through monetary policy and that attempting to do so inevitably leads to higher inflation and accelerating interest rates.

WILLIAM PROXMIRE.

ADDITIONAL VIEWS OF MR. RIEGLE

I believe that notwithstanding the monetary policy of the Federal Reserve Board, the rapid increase in indebtedness since 1980 has placed a mortgage on our future and is incompatible over time with economic and financial stability.

Currently, a number of indices in the economy show record or near record deficits.

In recent years—measured between 1980 and 1985—the Federal budget deficit has grown by 190 percent while nominal GNP grew by 46 percent.

The current account trade deficit has grown from a plus $1.8 billion in 1980 to a minus $115 billion in 1985.

Household disposable personal income rose by 46 percent but household debt rose by 71 percent.

And while the gross output of the nonfinancial corporate sector grew by 48 percent, the debt of that same sector grew by 79 percent.

Meanwhile, in the space of 6 years, we have reversed our position as the largest world creditor (net) and are in the process of rapidly becoming the largest world debtor. At current growth rates, our net international debt is projected to reach $1 trillion by 1990. This means that we will need a trade surplus of nearly $100 billion annually just to pay the interest on this massive debt without slipping further into debt.

Ultimately, I believe that these developments are both economically and politically unsustainable. In the process of highlighting the positive economic indicators of the moment we should not lose sight of the obvious and omnious danger signals that clearly lie ahead.

DONALD W. RIEGLE, JR.

Financial Transactions and the Rapid Rise of the Money Stock

The Federal Reserve has permitted the money stock (M1) to exceed its target ranges for most of the past six years. And the rise of money over the past six months has already nearly equaled the growth that the Fed had targeted for all of 1986.

Technically, the Fed has the power to force the money stock to follow any selected growth path (at least over longer periods of time) by adding or draining reserves from the banking system. Such changes in the supply of reserves affect the ability of banks to create demand deposits. They also influence interest rates and thus households and businesses' incentives to hold money balances.

Nevertheless, the Fed has been unwilling to exercise that power, since the sources of the explosive growth of the money stock are not clear. Before this decade, the money stock typically grew about three percentage points slower than nominal GNP on average. Since 1981, however, M1 has grown faster than GNP. In fact, M1 is now over $100 billion higher than it would have been if the traditional relationship between money and the economy had persisted. Given the breakdown of that relationship, any attempt by the Fed to push the money stock into its target range would have been undesirably destimulative to economic growth.

The search for explanations for the explosion of money growth relative to GNP growth has been intense. For instance, the Fed noted in its annual report on monetary policy in February that lower interest rates have encouraged households and businesses to hold more money balances, as the interest income earned by investing spare money has become less significant.

Researchers at the Fed are currently exploring the possibility that the unprecedented drop in rates since mid-1984 could be having a greater stimulative effect on money growth than previously estimated.

The Fed also has attributed some of the rise in the money stock to the deregulation of interest rates on certain types of checkable deposits, which has attracted funds into instruments that are included in M1. And most recently, the Fed has surveyed banks that have experienced rapid growth in their demand deposits as part of its attempt to uncover clues to explain the rapid growth of the money stock.

The rise of financial transactions

Those investigations, however, have produced partial explanations but no entirely satisfactory answers. Curiously, one fairly obvious explanation for rapid money growth has been ignored. One type of economic activity that is facilitated by the use of money balances -- the exchange of financial instruments -- has been soaring along with the money stock.

While much analysis has focused on the impact of interest rates on the money stock, the primary motive for holding money remains the execution of transactions. GNP has always been the standard measure of those transactions. But if analysts studied the relationship between money and the value of all transactions in the economy -- rather than the much narrower relationship between money and the final transactions measured by GNP -- there would be less puzzlement over money growth. A problem all along has been that the more comprehensive measure of total transactions is not available, at least as a direct measure.

GNP is an incomplete measure of the volume of transactions in the economy since it excludes exchanges of goods that are resold (intermediate

goods) as well as financial transactions. Money balances, however, are used in transactions involving both intermediate goods and financial instruments. In fact, those transactions that are excluded from GNP dwarf final transactions. Nevertheless, as long as the relationship between GNP and those excluded types of transactions remained stable, changes in GNP were a good proxy for changes in the total volume of economic transactions. But the relationship between GNP and the volume of financial transactions has been quite unstable over the past several years.

A direct measure of the total volume of financial transactions does not exist, but the volume of transactions on the New York Stock Exchange (NYSE) is one useful proxy.[1] The ratio of the volume of transactions on the NYSE to GNP had been relatively trendless until 1980, fluctuating between 8% and 20% (chart 1). That ratio has risen sharply since then, climbing to over 100% of GNP in the beginning of 1986. And the dollar volume of transactions by dealers in U.S. government securities — another proxy for the total volume of financial transactions — relative to GNP shows a similar pattern (chart 2). The volume of those transactions trended modestly upward in the 1970s before accelerating sharply over the past several years. And those proxies for the volume of financial transactions probably understate the rise in financial activity, as many of the latest innovations (such as interest-rate swaps and certain types of options and futures contracts) are the fastest growing.

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[1]The proxy is the product of the number of transactions on the NYSE and the NYSE composite price index. Several academic researchers have used the same proxy.

(CHART 1)

THE VOLUME OF TRANSACTIONS ON THE NEW YORK STOCK EXCHANGE
AS A PERCENT OF GNP
120
100
80
60
40
20
0
70
71
72
73
74
75
76
77
78
79
80
81
82
83
84
85
86

(CHART 2)

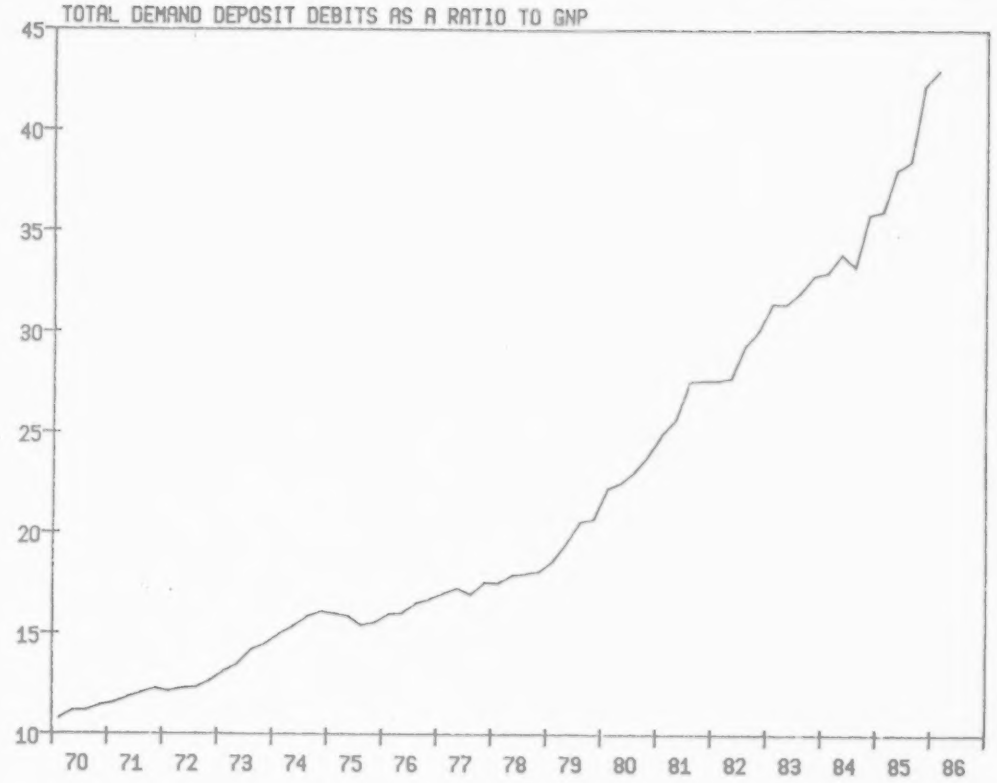
THE VOLUME OF TRANSACTIONS BY DEALERS IN U.S. GOV'T & AGENCY SECURITIES
AS A PERCENT OF GNP

Debits to demand deposits provide a more comprehensive, although less direct, measure of financial transactions than the two cited above. Demand deposits are debited for all kinds of transactions, both financial and nonfinancial. Those debits accelerated relative to GNP in the late 1970s, suggesting a speedup in the rise of financial transactions relative to final transactions (chart 3). As a result, the rapid rise in the money stock may be partly due to a rise in the volume of transactions -- particularly transactions that are not included in GNP.

The channels of causality

The surge of money balances held by households and businesses to facilitate the rise in financial transactions is impossible to quantify with any precision. Nevertheless, some channels by which financial transactions should impact the money supply are easy to identify. For instance, a recent article in The New York Times (June 10, 1986) noted that the use of banks to make interest payments on tax-exempt debt often leads to the creation of demand deposits. More specifically, banks receive funds from state and local governments to make such payments. Those funds are often placed in the state and local governments' demand deposit accounts, and they remain uncollected for an average of 11 days. The use of registered bonds in the tax-exempt market since mid-1983 has lessened this effect somewhat -- interest payments on those types of bonds are mailed directly to bondholders. But some investors (households, in particular) are prone to allowing balances to accumulate in noninterest-bearing accounts. In fact, the rise of debt in general relative to GNP since 1980 could be a factor in the rise of M1 relative to GNP if bondholders leave their interest payments in demand deposits or other checkable accounts for a period approximating

(CHART 3)


TOTAL DEMAND DEPOSIT DEBITS AS A RATIO TO GNP
45
40
35
30
25
20
15
10
70
71
72
73
74
75
76
77
78
79
80
81
82
83
84
85
86

the 11 days for interest paid on tax-exempt, bearer bonds. In this case, the "financial transaction" is the interest payment itself.

Examples of the accumulation of demand deposits by corporations for financial transactions are also available. For instance, banks often require corporations to hold larger compensating balances as the number of transactions for a particular account increases. And the number of "fails" -- instances in which a firm is left with a large balance in a noninterest-bearing account overnight -- also tends to rise with the number of transactions. A rise in financial transactions could cause a bulge in corporate demand deposits for both those reasons.

Dissecting money growth

If financial transactions are at least a partial factor in the strong growth of M1, the recent rapid rise of demand deposits and "other checkables" (NOWs and SuperNOWs) should characterize the entire period of significant increases in money relative to economic activity since those instruments are used in financial transactions rather than currency and travelers' checks (the other two components of M1). In fact, the growth of other checkables has indeed been rapid, suggesting that households (corporations are prohibited from using such accounts) could be using those accounts for financial transactions. On the other hand, however, demand deposit growth has been sluggish. Although that sluggishness is partly due to households' shift to the newer, interest-bearing other checkable accounts, it also clouds the issue of whether corporations (for which demand deposits are virtually the only means to make payments) are keeping larger balances in their demand deposit accounts to accomodate the increasing volume of financial transactions.

Unfortunately, the Fed's survey of the ownership of demand deposits does not include a separate category for corporations.[2] The Fed does, however, estimate the sum of currency and demand deposits held by corporations in the flow of funds accounts. Those estimates indicate that the sum of nonfinancial corporate cash (which is negligible) and demand deposits has averaged 7 1/2% growth each year since a decline in 1981, about twice the rate of increase for total demand deposits. Sluggish increases in total demand deposits, then, may be hiding a rise in those deposits by corporations after all.

Furthermore, statistical tests that measure the correlation of movements among different economic variables suggest that financial transactions have been a significant causal factor in the rapid rise of the money stock. Such tests, however, are not sufficiently reliable in the case of money growth to discern the magnitude of any such effect.

Conclusion

A variety of factors are responsible for the unexplained or "extra" money that now circulates in the economy. An important cause of the rise of that extra money is probably a change in the relationship between interest rates and the money stock. Another likely explanation is the use of M1 balances for savings rather than transactions purposes. Finally, of course, is the role of financial transactions. After all, households and businesses

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[2]The survey does, however, include "nonfinancial business" demand deposits, a category that includes noncorporate businesses' demand deposits as well as those of corporations. As a result, that category is depressed by the shift of noncorporate businesses' funds into other checkable accounts.

hold money first and foremost to facilitate transactions, with financial transactions increasingly dwarfing final transactions over the past several years.

Assigning actual magnitudes to each of those effects is virtually impossible by standard statistical methods, elevating the importance of basic theoretical insights and more casual observations. In the case of financial transactions, those considerations suggest a noteworthy role. For instance, the key theoretical insight of research on the demand for money is that transactions of any kind are the primary motivation for holding money balances. And empirical evidence gathered so far suggests that the magnitude of the impact of financial transactions is sufficiently large to be worth considering.

The Fed's tendency to permit M1 to drift above its target range has probably been necessary to some extent to sustain transactions in both goods and services as well as in financial instruments. Until the growth of financial transactions stabilizes relative to the growth of GNP, the signals sent by the money stock will be difficult to interpret and, indeed, misleading.

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